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Recommended Citation

Matthew J. Barrett, *Sarbanes-Oxley, Kermit the Frog, and Competition Regarding Audit Quality*, 3 J. Bus. & Tech. L. 207 (2008)
Available at: <http://digitalcommons.law.umaryland.edu/jbtl/vol3/iss2/2>

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MATTHEW J. BARRETT*

Sarbanes-Oxley, Kermit the Frog, and Competition Regarding Audit Quality

It's not easy bein' green. It could be nicer bein' red, yellow, or gold, or something much more colorful like that¹

Kermit the Frog

WHAT POSSIBLY COULD CONNECT KERMIT THE FROG to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "SOx")² or to audit quality, let alone both? Our gathering at the University of Maryland School of Law—very coincidentally on October 19, the twentieth anniversary of the 1987 stock market crash's Black Monday—surprisingly provides the answers.

First, consider Kermit, who likely would insist that we start with him. A larger-than-life-size bronze statue outside the University of Maryland's Adele Stamp Stu-

* Professor of Law, Notre Dame Law School. I gratefully acknowledge valuable research assistance from Patti Ogden and Tom Geagan, and helpful insights, comments or suggestions from James L. Fuehrmeyer, Patti Ogden, David N. Ricchiute, and the students in my Law & Accounting Seminar. Copyright © 2008, Matthew J. Barrett.

About three months after the symposium and shortly before the deadline for this piece, the U.S. Government Accountability Office (GAO) issued a report on continued concentration in the market for public company audits. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO No. 08-163, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION (2008), available at <http://www.gao.gov/new.items/d08163.pdf> [hereinafter CONTINUED CONCENTRATION]. The report updated a study that the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 701, 116 Stat. 745, 797 (Supp. V 2005), required on consolidation in the auditing industry. CONTINUED CONCENTRATION, *supra*, at 2; see also U.S. GEN. ACCOUNTING OFFICE, GAO No. 03-864, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION (2003), available at <http://www.gao.gov/new.items/d03864.pdf>. The more recent report examined concentration in the market for public company audits and its effects; the potential for midsize and smaller accounting firms to grow to ease market concentration; and various proposals to ease concentration and the barriers facing smaller firms in expanding their market shares. CONTINUED CONCENTRATION, *supra*, at 6. The proposals discussed included mandatory audit firm rotation, audit firm financial disclosure, breaking up the largest auditing firms, reducing litigation risk via liability caps, targeting enforcement actions against responsible individuals, changing how auditors attest to the fairness of financial statements, financial statement insurance, allowing outside ownership of accounting firms, creating a shared experts office, standardizing licensing and registration standards, and establishing an accounting firm accreditation program. *Id.* at 51–62. Ultimately, the report concluded that no compelling need for immediate action appears to exist. *Id.* at 51. The report, however, did not address the proposal in this piece.

1. KERMIT, (*It's Not Easy*) *Bein' Green*, on BEST OF THE MUPPETS (Disney 2005).

2. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

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dent Union on the College Park campus honors Jim Henson, one of the University's most distinguished graduates and the creator of the Muppets.³ The statue depicts Henson sitting on a bench, talking to Kermit, perhaps the most beloved, as well as the most analytical and thoughtful, muppet.⁴ Henson, who earned his bachelor of science degree in 1960 and received an honorary doctor of fine arts degree eighteen years later, created Kermit and numerous other muppets while a college student.⁵

Next, reflect on the date. Exactly twenty years before this Symposium, inflation fears arising from growing deficits in foreign trade and the federal budget caused a dramatic loss in investor confidence.⁶ On October 19, 1987, the Dow Jones Industrial Average (DJIA) suffered a 508-point drop, plunging 22.6%, its largest one-day percentage decline in history.⁷ To help shaken investors and the American public, ABC News broadcast a special edition of *Nightline* that featured a national town hall meeting with Ted Koppel, a panel of experts, and none other than the Muppets to explain Black Monday and the loss of investor confidence that accompanied those events.⁸

Now, to complete the picture, cut to about five years ago when investor confidence suffered another beating from the corporate frauds at Enron, WorldCom, and numerous other firms. Those scandals, and the accounting profession's leading role in them, promptly led to Sarbanes-Oxley's enactment.

So, on the anniversary of Black Monday here at Jim Henson's alma mater, we might seek an encore for the *Nightline* idea. Although the Muppets did not attend this Symposium, we can imagine enlisting them to help explain the need for SOx and to critique that legislation and its effect on the regulation of accountants. From that starting point, this short paper concludes that, with one major exception, the new regulatory scheme overseeing the firms and accountants who audit the public companies in the United States already has either significantly improved audits and

3. University of Maryland Alumni Association, Alumni Hall of Fame Members, http://www.alumni.umd.edu/about/alumnihallfame_bios.html (last visited Mar. 9, 2008).

4. Adrienne Saunders, *Muppet Tribute; Puppeteer Jim Henson and Kermit the Frog are Together Forever in Bronze in a University of Maryland Statue that Celebrates their Creative Collaboration*, BALT. SUN, Sept. 15, 2003, at D1. Interested readers can view this statue at <http://www.stylishlyapt.com/images/lj/sunday/2007-10-21.jpg> (last visited Mar. 9, 2008).

5. University of Maryland Alumni Association, *supra* note 3.

6. See, e.g., E.S. Browning, *Exorcising Ghosts of Octobers Past*, WALL ST. J., Oct. 15, 2007, at C1; Edward Hadas, *Financial Insight: A Basic Lesson in Finance; What Economists Learned Following Black Monday*, WALL ST. J., Oct. 15, 2007, at C14; A. Gary Shilling, *Business Forum: America's Financial Markets; Frankfurt and Tokyo Take Control*, N.Y. TIMES, Sept. 11, 1988, at A3. But see Cindy Skrzycki, *Collapse Shakes Core of Confidence in Economy*, WASH. POST, Oct. 25, 1987, at A18 (describing the reasons why the crash happened when it did as "mystifying").

7. See Robert A. Bennett, *Stocks Plunge 508 Points, a Drop of 22.6%*, N.Y. TIMES, Oct. 20, 1987, at A1.

8. *Nightline: A National Town Meeting on Wall Street and the Economy* (ABC News television broadcast Nov. 6, 1987), on ABC News, *Nightline: Town Meeting on Wall Street and the Financial State of NY/Muppets* (2007).

auditing here or demonstrated the potential to do so.⁹ Client confidentiality, however, remains a significant barrier to competition regarding audit quality among auditors for public companies. In an effort to overcome this barrier, this piece calls upon the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) to take certain actions, already within their statutory and regulatory authorities, to increase competition over audit quality.

GREEN SOX AND REGULATION OF THE ACCOUNTING INDUSTRY

Embracing the theory that commentators never can overuse sports metaphors, residing in South Bend, Indiana, following professional baseball for much of my life, and participating in this Symposium in the shadows of Camden Yards, the Baltimore Orioles' home ball park, I might refer to Sarbanes-Oxley as either "White SOx," "Black SOx," "Red SOx," or "Blue SOx."¹⁰ But not Kermit. No, he surely would dub Sarbanes-Oxley "Green SOx,"¹¹ and with good reason. As several other Symposium participants complained, the legislation has caused numerous corporate executives, lawyers, auditors, regulators, and academics to "turn green." Kermit, however, also might note that given the steady rise in stock prices in the U.S. capital markets since Sarbanes-Oxley's enactment, the legislation indeed has earned the distinction of "Green SOx."

Although Kermit readily would admit that he cannot prove causation, he might nevertheless point out that approximately ten years ago, on October 10, 1997, the DJIA closed at 8,045.21.¹² After increasing to more than 11,000 on May 3, 1999,¹³ the DJIA had dropped to 8,264.39 on July 26, 2002, the Friday before President George W. Bush signed Sarbanes-Oxley.¹⁴ From that date through Friday, October 12, 2007, when the DJIA closed at 14,093.08, the indicator had achieved average

9. See CONTINUED CONCENTRATION, *supra* note *, at 5, 32 (reporting the views of most market participants and many survey respondents that audit quality has improved since Sarbanes-Oxley's enactment). At least some industry participants, however, expressed concerns that market concentration has adversely affected audit quality. *Id.* at 32.

10. The South Bend Blue Sox played from 1943 to 1954 in the All-American Girls Professional Baseball League. All-American Girls Professional Baseball League Players Association, <http://aagpbl.org/teams.cfm> (last visited Mar. 9, 2008).

11. In fact, although hundreds of articles address Sarbanes-Oxley, to my knowledge no other commentator has referred to the legislation as "Green SOx" in published writing. Searching both Westlaw's full-text database of "All Texts, Treatises, Law Reviews and Journals" and Lexis-Nexis's full-text "US Law Reviews and Journals, Combined" in January 2008 did not produce any documents. A Google search found only four results, none containing this specific reference.

12. Yahoo! Finance, Historical Prices, Dow Jones Industrial Average Index, Oct. 10, 1997, <http://finance.yahoo.com/q/hp?s=%5EDJI&a=09&b=10&c=1997&d=09&e=10&f=1997&g=d> (last visited Mar. 9, 2008).

13. Yahoo! Finance, Historical Prices, Dow Jones Industrial Average Index, May 3, 1999, <http://finance.yahoo.com/q/hp?s=%5EDJI&a=04&b=3&c=1999&d=04&e=3&f=1999&g=d> (last visited Mar. 9, 2008).

14. Yahoo! Finance, Historical Prices, Dow Jones Industrial Average Index, July 26, 2002, <http://finance.yahoo.com/q/hp?s=%5EDJI&a=06&b=26&c=2002&d=06&e=26&f=2002&g=d> (last visited Mar. 9, 2008).

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annual gains equaling 10.8%.¹⁵ From July 26, 2002 to October 12, 2007, other indices enjoyed similar increases, with the Standard & Poors 500 gaining an average 12.3% per year over that period,¹⁶ the Wilshire 5000 rising 13.7%,¹⁷ the Russell 2000 recording a 16.3% annual accretion,¹⁸ and Nasdaq posting a 16.6% annualized gain.¹⁹

After pointing out the solid gains various market indices have recorded in the past five years, Kermit might offer an overall assessment of Sarbanes-Oxley by observing that the legislation has rebuilt public confidence in the integrity of the nation's capital markets.²⁰ As evidence, he might point to a recent Center for Audit Quality survey, which found that 79% of investors responding opined that the changes brought about by Sarbanes-Oxley had increased their confidence in audited financial information in the United States.²¹ In addition, our amphibious friend might remind us that the reforms have somehow found a way to avoid the horror stories that we repeatedly read in the early 2000s,²² and helped to uncover the numerous and more recent scandals involving backdated stock options.²³

15. See Yahoo! Finance, Historical Prices, Dow Jones Industrial Average Index, Oct. 12, 2007, <http://finance.yahoo.com/q/hp?s=%5EDJI&a=09&b=12&c=2007&d=09&e=12&f=2007&g=d> (last visited Mar. 9, 2008). Return calculation: x is annual return, where $(1 + x)^y = (\text{last day close} \div \text{first day close})$ and $y = \text{years between first day and last day}$.

16. See Yahoo! Finance, Historical Prices for S&P 500 Index, July 26, 2002–Oct. 12, 2007, <http://finance.yahoo.com/q/hp?s=%5EGSPC&a=06&b=26&c=2002&d=09&e=12&f=2007&g=m> (last visited Mar. 9, 2008).

17. See Yahoo! Finance, DJ Wilshire 5000 Index, July 26, 2002–Oct. 12, 2007, <http://finance.yahoo.com/q/hp?s=%5EDWC&a=06&b=26&c=2002&d=09&e=12&f=2007&g=d> (last visited Mar. 9, 2008).

18. See Yahoo! Finance, Russell 2000 Index, July 26, 2002–Oct. 12, 2007, <http://finance.yahoo.com/q/hp?s=%5ERUT&a=06&b=26&c=2002&d=09&e=12&f=2007&g=d> (last visited Mar. 9, 2008).

19. See Yahoo! Finance, Historical Prices for Nasdaq Composite, July 26, 2002–Oct. 12, 2007, <http://finance.yahoo.com/q/hp?s=%5EIXIC&a=06&b=26&c=2002&d=09&e=12&f=2007&g=d> (last visited Mar. 9, 2008).

20. See, e.g., Thomas J. Healey, *Sarbox Was the Right Medicine*, WALL ST. J., Aug. 9, 2007, at A13; Rachel McTague, *Sarbanes-Oxley Authors, Regulators Say Act Restored Confidence in Financial Statements*, 5 Corp. Accountability Rep. (BNA) 788 (Aug. 3, 2007).

21. See CTR. FOR AUDIT QUALITY, RESEARCH SUMMARY 1 (2007), available at <http://www.thecaq.org/events/sox/researchsummary.pdf> (presenting results from a telephone survey conducted during July 17–23, 2007); see also Rachel McTague, *SOX Boosted Faith in Financials; Cox: Smaller Firm 404 Delay Not Ruled Out*, 39 Sec. Reg. & L. Rep. (BNA) 1228 (Aug. 6, 2007). The telephone poll asked 1,001 investors nationally various questions related to investing, the capital markets, and Sarbanes-Oxley. CTR. FOR AUDIT QUALITY, *supra*. As a recently formed industry group affiliated with the American Institute of Certified Public Accountants, the Center for Audit Quality has emerged as the Big Four's voice on accounting issues. See David Reilly, *With New, United Voice, Auditors Stand Ground on How to Treat Crunch*, WALL ST. J., Oct. 17, 2007, at C1.

Not all surveys have produced such a positive reaction to Sarbanes-Oxley's reforms. Although admittedly not statistically significant, the law firm Foley & Lardner LLP recently found that 84% of its respondents described the corporate governance and public disclosure reforms implemented since Sarbanes-Oxley as "too strict." See Malini Manickavasagam, *Hike in Audit Fees Levels Off; Small Firms Still Bearing Burdensome Costs, Study Finds*, 5 Corp. Accountability Rep. (BNA) 811 (Aug. 10, 2007).

22. See, e.g., Herb Greenberg, *Accounting Scandals: Not a Problem?*, WALL ST. J., July 7, 2007, at B3.

23. See 15 U.S.C. § 78p(2)(C) (Supp. V 2005); see also M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1639 (2007) (noting that SOX has reduced backdating practices, but not entirely eliminated them).

With regard to the accounting profession, Kermit likely would note that the legislation has increased awareness of the importance of accounting and auditing to corporate governance, removed the right of self-regulation from the accounting profession, and eliminated the auditing firms' ability to provide most consulting services to audit clients, while offering the profession the opportunity to provide additional services via section 404, albeit with a high price to morale.²⁴ Always prudent, Kermit also might caution, however, that the auditing profession continues to face several significant challenges that the Sarbanes-Oxley reforms have yet to address.²⁵ Spurred by our wise frog's observations, we can examine one remaining problem and offer some specific suggestions for additional reforms.

According to the Treasury Department's Advisory Committee on the Auditing Profession,²⁶ the capital markets and the investing public need a strong and vibrant auditing profession that can audit public companies operating globally.²⁷ Industry concentration and lack of competition within the auditing industry, however, threaten our nation's capital markets.²⁸ Accounting firm mergers and Arthur Andersen's demise have reduced the "Big Eight" to the current "Big Four," sometimes referred to as the "Final Four," a group that audits the vast majority of all public companies in the United States.²⁹ In certain industries, large public companies may

24. See DAVID R. HERWITZ & MATTHEW J. BARRETT, *MATERIALS ON ACCOUNTING FOR LAWYERS* 154, 200, 205–06, 219–22 (unabr. 4th ed. 2006); see also CONTINUED CONCENTRATION, *supra* note *, at 10–11; Henry M. Paulson, Treasury Sec'y, U.S. Dep't of Treasury, Remarks at the Economic Club of NY on the Competitiveness of U.S. Capital Markets (Nov. 20, 2006), available at <http://www.treas.gov/press/releases/hp174.htm> (asserting that "a significant portion of the time, energy, and expense associated with implementing section 404 might have been better focused on direct business matters that create jobs and reward shareholders"); Alan Murray, *For Sarbanes-Oxley Bashers, Some Perspective*, WALL ST. J., Nov. 16, 2005, at A2 (expressing annoyance that "a law [referring to section 404] passed in response to accounting scandals has led to the proliferation and enrichment of accountants").

25. See, e.g., Steven Marcy, *Fraud, Liability, Education Top Issues at First Auditor Advisory Panel Meeting*, 5 Corp. Accountability Rep. (BNA) 1053 (Oct. 19, 2007); Deborah Solomon, *Auditing the Auditors After Sarbanes-Oxley*, WALL ST. J., Oct. 3, 2007, at C2.

26. In May 2007, Treasury Secretary Henry M. Paulson announced a non-partisan committee to consider options to strengthen the auditing industry's financial soundness and ability to attract and retain qualified personnel and to offer recommendations. See Press Release, U.S. Dep't of Treasury, Paulson Announces First Stage of Capital Markets Action Plan (May 17, 2007) [hereinafter Press Release, Capital Markets], available at <http://www.treas.gov/press/releases/hp408.htm>; Press Release, U.S. Dep't of Treasury, Paulson Announces Auditing Committee Members to Make Recommendations for a More Sustainable, Transparent Industry (Oct. 2, 2007), available at <http://www.treas.gov/press/releases/hp585.htm> (listing committee members); see also Advisory Committee on the Auditing Profession, 72 Fed. Reg. 33,560 (June 18, 2007).

27. See Paulson, *supra* note 24 (asking questions about competition in the accounting industry and the current system's ability to produce high-quality audits and to attract the talented auditors necessary for such audits); see also CONTINUED CONCENTRATION, *supra* note *, at 17 (observing that as U.S. corporations have expanded into global markets, their need for auditing firms with greater global reach has also increased); Press Release, Capital Markets, *supra* note 26.

28. See, e.g., Henry M. Paulson, Treasury Sec'y, U.S. Dep't of Treasury, Statement at Press Conference on Advisory Committee on the Auditing Profession (Oct. 2, 2007), available at <http://www.treas.gov/press/releases/hp586.htm>.

29. See CONTINUED CONCENTRATION, *supra* note *, at 4, 16, 75 (finding that in 2006 the "Big Four" audited 98% of the more than 1,500 largest public companies with annual revenues exceeding \$1 billion and collected more than 94% of fees paid for public company audits). Each of these largest firms, namely, Deloitte

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face even more limited choices because not all of the Big Four actively work in those industries.³⁰ According to a recent study by the U.S. General Accountability Office (GAO) on auditor concentration, industry expertise and technical capacity generally limit the largest public companies' choices to the Big Four.³¹ Almost 60% of large public companies surveyed described the number of accounting firms from which they could choose their auditor as not adequate.³² Of particular concern, a merger or the failure of a Big Four firm would further reduce public companies' auditor choices.³³ Although audit quality has improved following the audit failures at Enron, WorldCom and numerous other public companies,³⁴ more than 10% of public companies restated their financial statements during 2006.³⁵ With so few firms, reduced competition reduces incentives to invest in reputation.³⁶ Other issues confronting the auditing profession include its ability to attract and retain human capital;³⁷ to obtain financial resources, including insurance or limited legal

& Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP, includes thousands of partners, tens of thousands of employees, and offices located around the globe, and each audited more than 1,200 public companies for 2006. *See id.* at 1 nn.2-3.

30. *See id.* at 23 app. II at 78-79 (noting that Ernst & Young accounted for 77% of all audit fees in the agriculture, forestry, fishing, and hunting industry in 2006, while another member of the Big Four held only a 1% market share).

31. *See id.* at 4. Approximately 90% of the large public companies that responded to the GAO survey indicated that lack of capacity prevented them from considering second- or third-tier firms as their auditor. *See id.* at 5, 15; *see also* Helen Roybark, *An Analysis of Audit Deficiencies Based on PCAOB Inspection Reports Issued During 2005*, 6 J. ACCT. ETHICS & PUB. POL'Y 125, 146 (2006) (listing staff resources, industry-specific and technical expertise, geographic limitations, and national and international reputations as the significant challenges and barriers that smaller auditing firms face); Diya Gullapalli, *Firms' Auditor Choices Dwindle*, WALL ST. J., June 21, 2005, at C1 (reporting that some large public companies assert that only the Big Four offer enough staff, expertise, and offices world-wide to handle their audits).

32. *See* CONTINUED CONCENTRATION, *supra* note *, at 4, 23. By comparison, about 75% of the smallest public companies responding to the GAO survey described their number of potential auditors as sufficient. *See id.* at 4.

33. *See id.* at 5, 15; *see also* Deborah Solomon & Diya Gullapalli, *SEC Weighs a 'Big Three' World*, WALL ST. J., June 22, 2005, at C1 (discussing various alternatives if the Justice Department indicted KPMG LLP for selling unlawful tax shelters).

34. *See* CONTINUED CONCENTRATION, *supra* note *, at 5.

35. Rachel McTague, *SEC's 17-Member Advisory Panel on Financial Reporting Agrees on Focus*, 5 Corp. Accountability Rep. (BNA) 812 (Aug. 10, 2007). In establishing the Department of the Treasury's Advisory Committee on the Auditing Profession, Treasury Secretary Paulson noted that financial restatements soared to 1,876 in 2006, a number that translates to more than 10% of public companies. *See* Press Release, U.S. Dep't of Treasury, Paulson: Financial Reporting Vital to U.S. Market Integrity, Strong Economy (May 17, 2007), available at <http://www.treas.gov/press/releases/hp407.htm>; *see also* Steve Burkholder, *SEC's Hewitt Supports, Sees Need For Treasury Study on Restatements*, 5 Corp. Accountability Rep. (BNA) 1230 (Dec. 14, 2007); David Reilly, *After Losses, Auditors Take a Hard Line*, WALL ST. J., Feb. 13, 2008, at C1 (reporting that research firm Audit Analytics found that the number of restatements fell to 1,237 during 2007, down from a record 1,801 the year before, while Glass Lewis & Co. concluded that the number had dropped from 1,346 in 2006 to 1,172 in 2007).

36. *See* Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323, 346 (2007).

37. *See* Paulson, *supra* note 24. The auditing profession continues to suffer from high employee turnover, which often reaches 15% in any given year. *See* Marcy, *supra* note 25.

liability;³⁸ and to protect and communicate with investors, especially with regard to an audit's limited ability to detect fraud.³⁹

A MODEST PROPOSAL TO IMPROVE COMPETITION REGARDING AUDIT QUALITY

In general, service providers, including auditors, compete on some combination of price and quality.⁴⁰ In the late 1990s, accounting firms used low-priced audit services as a "loss leader" in an effort to secure more lucrative consulting engagements.⁴¹ More recently, some industry experts have warned that large discounts from standard rates disproportionately accompany audit failures.⁴² While the Big Four firms often point to their status within this group as evidence of the quality of their audit services, investors and audit committees alike would benefit from more information about the value and effectiveness of audits at particular registered public accounting firms, both within the Big Four and in other tiers.⁴³ Accordingly, this paper offers a modest proposal to increase competition as to audit quality by proposing that the SEC mandate issuers and registrants to disclose whether their independent audits uncovered any financial fraud and, within specified ranges, the number and amount of all audit adjustments ultimately incorporated into the financial statements. Because issuers and registrants would disclose this information in their filings with the SEC, the information would enter the public domain. Once

38. Marcy, *supra* note 25.

39. See *id.*; Solomon, *supra* note 25.

40. Industry experts agree that we cannot directly observe audit quality. Accountants, however, have constructed conceptual and empirical proxies for audit quality. For example, in one conceptual construction an accounting academic has defined, at least implicitly, audit quality as the probability that an auditor will detect and report a material misstatement. See Linda DeAngelo, *Auditor Independence, 'Low Balling', and Disclosure Regulation*, 3 J. ACCT. & ECON. 113, 115 (1981); see also Hyeesoo Chung & Sanjay Kallapur, *Client Importance, Nonaudit Services, and Abnormal Accruals*, 78 ACCT. REV. 931, 934 (2003). By comparison, one empirical construction defines audit quality as abnormal accruals, meaning the unexpected difference between actual and estimated total accruals. See *id.* at 951. Unlike my proposal, also a proxy for audit quality, researchers have deployed such conceptual and empirical proxies in the accounting literature to study aggregate behavior across samples of registrants, rather than to report individual behavior within a single registrant. In addition, my proposal, which seeks to publicize the actual number and actual amount of audit adjustments, measures directly what abnormal accruals measure indirectly.

41. See Matthew J. Barrett, *Enron and Andersen—What Went Wrong and Why Similar Audit Failures Could Happen Again*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 155, 159, 163 (Nancy B. Rapoport & Bala G. Dharan eds., 2004) (describing how Arthur Anderson "marketed more lucrative consulting services to its audit clients"); see also CONTINUED CONCENTRATION, *supra* note *, at 29 (positing that the new independence requirements explain the new reluctance to price audits as a loss leader in an effort to sell nonaudit services).

42. 10 Ways to Ensure a Rock-Solid Financial Statement Audit, FIN. ANALYSIS PLAN. & REPORTING, Oct. 2004, at 1.

43. After the Big Four, the next four largest accounting firms, the so-called "second tier," which includes BDO Seidman LLP, Crowe Chizek & Company LLC, Grant Thornton LLP, and McGladrey & Pullen LLP, each audited more than 100, but fewer than 425, public companies for 2006 and generated \$1 billion or less in revenue. These firms, sometimes referred to as "midsize firms," operate nationally, and to some extent, internationally, but include substantially fewer employees and partners. See CONTINUED CONCENTRATION, *supra* note *, at 1–2 n.4. The smaller firms, which we might classify as the "third tier," audit fewer than 100 public companies each year, usually regional and local public companies. See *id.* at 2.

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public, a registered public accounting firm could use that information, plus perhaps data about the infrequency of any restatements to financial statements on which the firm had expressed an unqualified opinion, to evidence the quality of the firm's audits relative to that of its competitors. In addition, the PCAOB could include such information in its inspection reports. Such a proposal would enable the participants in our capital markets, including audit committees and investors, to better assess the quality and value of the independent audits that registered public accounting firms provide. Indeed, in its recent study on continued concentration in the audit market for large public companies, the GAO highlighted comments from market participants who found conducting due diligence on unfamiliar auditing firms time-consuming.⁴⁴ The participants observed that they could not readily access information about such auditing firms' reputations or ability to undertake high quality audits.⁴⁵

At present, client confidentiality imposes a major barrier to audit competition regarding audit quality. Imagine Bert & Ernie, LLP, a registered accounting firm, which seeks the audit engagement at The Muppets, Inc. In pursuing this possible engagement, Bert and Ernie cannot lawfully tell Statler and Waldorf, the company's audit committee, that during the last year their audits led to x audit adjustments totaling \$Y. Nor could they disclose that they uncovered a fraud at Swedish Chef & Co., another public company that had been cooking its books. Such disclosures, which Statler and Waldorf could not verify easily, typically would violate client confidentiality.⁴⁶ Although material financial frauds at public companies usually eventually become public,⁴⁷ audit adjustments arising from less nefarious errors and omissions easily can escape the public's "radar screen." Mandatory disclosures regarding such audit adjustments, which involve correction of a public company's current or past financial statements, would put this information in the public domain and supply additional evidence about audit quality and the value of audits, and at the same time provide valuable insight into the quality of the enterprise's internal controls.

44. See *id.* at 43.

45. See *id.*

46. Unless the Rules of the Code of Professional Conduct of the American Institute of Certified Public Accountants permit, generally accepted auditing standards preclude an auditor from disclosing confidential information obtained in the course of an engagement absent client consent. See COMMUNICATIONS BETWEEN PREDECESSOR AND SUCCESSOR AUDITORS, Statement on Auditing Standards No. 84, § 8 (Am. Inst. of Certified Pub. Accountants 1997), reprinted as amended in 1 AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS (as of June 1, 2003) AU § 315.08 (2003). While the PCAOB has begun to develop its own standards, it has adopted as "Interim Professional Auditing Standards" those standards that the accounting profession, through the American Institute of Certified Public Accountants and that organization's Auditing Standards Board, had promulgated as of April 16, 2003. See Professional Standards, Rule 3200T (Pub. Co. Accounting Oversight Bd. 2006), available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Section_3.pdf.

47. The investing public typically does not learn how the issuer or registrant discovered the problem.

LIKELY BENEFITS

Such a proposal offers four significant benefits that arguably overcome potential criticisms. First, the proposal works within the existing legal and regulatory environment, thereby allowing more time for Sarbanes-Oxley reforms to take root as well as giving the SEC and PCAOB the opportunity, when necessary, to tweak existing regulatory standards.⁴⁸ In that regard, SOx section 401(a) already requires public companies to record in the financial statements they file with the SEC all material correcting adjustments their independent auditors identify in accordance with generally accepted accounting principles and the SEC's rules and regulations.⁴⁹ Furthermore, generally accepted auditing standards state that the auditor *should* inform the audit committee about all proposed corrections to the financial statements, whether or not recorded, arising from the audit that, "in the auditor's judgment, may not have been detected except through the auditing procedures performed."⁵⁰ Moreover, the PCAOB standard on audit documentation requires the auditor to document significant findings or issues, including audit adjustments.⁵¹ Finally, the auditor also must identify all significant findings or issues in an engagement completion document.⁵² As a result, current auditing practice already documents and communicates information about audit adjustments. Akin to the new requirements that public companies disclose additional information about executive compensation, the SEC could adopt rules that require issuers and registrants to disclose information about frauds detected during external audits and any audit adjustments.⁵³

48. Commentators have praised the flexibility of the regulatory framework in Sarbanes-Oxley as one of the legislation's particular strengths. See, e.g., Healey, *supra* note 20; McTague, *supra* note 20.

49. SOx section 401(a) provides:

Each financial report that contains financial statements, and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles under this title and filed with the Commission shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.

Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 401(a), 116 Stat. 745, 785 (codified at 15 U.S.C. § 78m(i) (Supp. V 2005)).

50. COMMUNICATION WITH AUDIT COMMITTEES, Statement on Auditing Standards No. 61, § 9 (Am. Inst. of Certified Pub. Accountants 1988), *reprinted as amended in* 1 AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS (as of June 1, 2003) AU § 380.09 (2003); see *supra* note 46.

51. AUDIT DOCUMENTATION, Auditing Standard No. 3, § 12 (Pub. Co. Accounting Oversight Bd. 2007), available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_3.pdf. The standard defines an "audit adjustment" as a "correction of a misstatement of the financial statements that was or should have been proposed by the auditor, whether or not recorded by management, that could, either individually or when aggregated with other misstatements, have a material effect on the company's financial statements." *Id.* § 12(c).

52. *Id.* § 13.

53. See Executive Compensation and Related Person Disclosure, Securities Act Release No. 8,732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,158, 53,241-52 (Sept. 8, 2006) (codified in most relevant part at 17 C.F.R. § 229.402 (2007)).

COMPETITION REGARDING AUDIT QUALITY

Second, the proposal encourages more accurate financial statements, stronger internal controls, and more effective internal audit functions, all of which should benefit a public company through a reduced cost of capital.⁵⁴ The proposal allows *positive* competition, based on objective criteria, on audit quality in two different ways. Initially, audit firms could better compete with each other, especially within tiers, regarding audit quality. When appropriate, a Big Four firm might tell the audit committees at existing or prospective audit clients that its auditors uncovered more financial frauds or required more audit adjustments, whether in number or dollar amount, than any other member of the Big Four, either overall or within a particular industry or geographic region.⁵⁵ Combined with existing information regarding restatements, the Big Four thereby could more easily compete with each other regarding audit quality. Second-tier and regional firms also could better compete with each other. Indeed, the proposal eventually might allow second-tier auditing firms to expand their audit practices and to enhance their reputations sufficiently to compete with the Big Four.⁵⁶

Third, the proposal's implementation should enhance the stature of auditors and the auditing profession, which in turn should help auditing firms to attract and retain human capital.⁵⁷ As a starting point, the proposal will increase the capital markets' ability to quantify the financial frauds that independent audits uncover and the adjustments that those audits initiate. If independent audits continue to find financial frauds and audit adjustments and reduce the number of restatements, we can expect the public to recognize an audit's value and the auditing profession's

54. See, e.g., Jan Barton, *Who Cares About Auditor Reputation?*, 22 CONTEMP. ACCT. RES. 549, 581 (2005) (concluding that managers of firms more visible in the capital markets "appear to engage highly reputable auditors as part of a strategy to build a reputation for financial reporting credibility, presumably to secure external financing at lower cost"); Christine A. Botosan, *Disclosure and the Cost of Capital: What Do We Know?*, 2006 ACCT. & BUS. RES. 31, 39 (concluding that "evidence accumulated across many studies using alternative measures, samples and research designs lends considerable support to the hypothesis that greater disclosure reduces cost of equity capital"); cf. Jacqueline S. Hammersley, Linda A. Myers & Catherine Shakespeare, *Market Reactions to the Disclosure of Internal Control Weaknesses and to the Characteristics of those Weaknesses under Section 302 of the Sarbanes Oxley Act of 2002* (Jan. 2007) (unpublished manuscript, available at <http://ssrn.com/abstract=951085>) (concluding that disclosures about internal control weaknesses provide helpful information to investors).

55. The SEC would need to articulate specific definitions for fraudulent activity and material audit adjustments. For example, the SEC could limit so-called "fraudulent activity" to circumstances where a director, officer, or employee pleads guilty to a criminal offense or a jury convicts such an individual. With regard to audit adjustments, the SEC might establish ranges for material recorded changes arising from an independent audit, potentially beginning at an amount as low as \$10,000. For example, the rules might require disclosures about the number of audit adjustments between \$10,000 and \$99,999, \$100,000 and \$249,999, etc., along with a requirement that the issuer or registrant disclose the cumulative amount of adjustments within the particular range.

56. See CONTINUED CONCENTRATION, *supra* note *, at 48 (observing that some midsize and smaller audit "firms have expanded their audit practices in niches that allow them to [leverage their expertise and] build their reputations in specialty areas," which, in turn, has enabled them to acquire progressively larger clients and to grow incrementally). In addition, resulting mergers and acquisitions can allow midsize and smaller audit firms to add new industry expertise, increase their capacity, and extend their geographic reach. See *id.*

57. See *supra* note 37 and accompanying text.

reputation to grow. Next, the proposal creates positive rewards for auditing firms and individual auditors who detect frauds or items that require adjustment.⁵⁸ At present, financial or other incentives still tempt auditing firms and their executives and employees to try to retain an audit engagement. Even after Sarbanes-Oxley, unconscious bias threatens to cause audit failures.⁵⁹ If the capital markets reward public companies that hire auditing firms which have demonstrated their ability to find financial frauds and audit adjustments, those firms will in turn reward individual auditors for their auditing expertise. When auditors conclude that uncovering frauds or finding misstatements will advance their careers, they will try harder to detect such items.

Finally, the PCAOB could improve its reputation by including information about audit adjustments and any frauds detected in its inspection reports. Each year, the PCAOB reviews selected audit and review engagements at various auditing firms, including any firm that regularly audits more than one hundred public companies.⁶⁰ At present, PCAOB inspections seek “to identify and address weaknesses and deficiencies related to how a firm conducts audits.”⁶¹ Accordingly, PCAOB inspection reports concede that they “are not intended to serve as balanced report cards or overall rating tools.”⁶² PCAOB inspection reports, however, could quantify, and perhaps even verify, the number of audit adjustments and financial frauds that each firm identified within certain specified dollar ranges, as well as the number of intentional misstatements uncovered. Such inspection reports would communicate valuable information to audit committees and investors, which would enhance the PCAOB’s reputation.⁶³ Ultimately, the information about the auditor’s track record on audit quality may offer a mode of communication more useful than the current audit report.⁶⁴

58. Some commentators from the legal academy have argued that audit client capture will remain a problem until auditing firms reward auditors for superior audit work, such that finding and addressing problems enhances an auditor’s career. See, e.g., Jonathan Macy & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1168, 1186–87 (2003).

59. See Barrett, *supra* note 41, at 166.

60. Sarbanes-Oxley requires annual inspections for accounting firms that regularly provide audit reports for more than 100 issuers. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 104(b)(1)(A), 116 Stat. 745, 757 (codified at 15 U.S.C. § 7214(b)(1)(A) (Supp. V 2005)).

61. See, e.g., PUB. CO. ACCOUNTING OVERSIGHT BD., REPORT ON 2006 INSPECTION OF KPMG LLP 2 (2007), PCAOB Release No. 104-2007-106, at 2 (2007), available at http://www.pcaobus.org/Inspections/Public_Reports/2007/KPMG2006.pdf.

62. *Id.* at 2 n.3; see also CONTINUED CONCENTRATION, *supra* note *, at 43 (noting that PCAOB inspection reports do not offer an overall judgment on the quality of a firm’s audits or its audit capabilities); Roybark, *supra* note 31, at 148 (observing that because the PCAOB inspection reports do not mention audits where the inspection team did not identify any deficiencies or where the deficiencies did not exceed the PCAOB’s significance threshold, the reporting process precludes any overall judgment about audit quality).

63. Alternatively, the PCAOB could use public recognition, such as an “Auditor of the Year” award or similar honors to highlight outstanding auditing. See, e.g., Cunningham, *supra* note 36, at 379.

64. See Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698, 1735 (2006).

COMPETITION REGARDING AUDIT QUALITY

POTENTIAL CRITICISMS

Skeptics might offer three concerns about the proposal, arguing that the proposal might encourage gaming, the suggested disclosures may not improve investor confidence in financial statements, and the recommendation increases potential conflicts between auditors and clients. First, the recommended initiative might give auditors the incentive to assert numerous smaller audit adjustments, while registrants might prefer to combine smaller adjustments into a single, larger adjustment. Registrants also might prefer to attribute adjustments to a rogue employee's fraud. To counter this problem, the SEC will need to articulate specific definitions for fraudulent activity and material audit adjustments and should include "anti-abuse" prohibitions to deter any such gaming.

Second, an opponent might point to investor ambivalence and assert that the proposed disclosures would not improve investor confidence in financial statements. As an initial response to this potential criticism, the proposal seemingly does not implicate any disclosure overload. Perhaps more significantly, however, a critic might argue that as long as financial statements do not contain material misstatements or omissions, investors in fact do not care whether any errors get caught and corrected, as long as they do not affect the financial statements the enterprise ultimately files with the SEC. The proposal, however, assumes investors indeed draw distinctions between mistakes and intentional errors that give rise to criminal liability. Similarly, an opponent might argue that the proposal could encourage spending on internal controls and internal audits at the expense of external audits. If anything, we should err in favor of supposing that investors do indeed care whether an enterprise's internal controls and internal audit function effectively prevent or detect any errors before the independent auditor begins the audit.⁶⁵

Finally, the new reporting requirement adversely would increase the potential conflicts between auditors and clients. Numerous auditors continue to believe that audit success ultimately depends on the client's cooperation. After Sarbanes-Oxley, however, both the legislation and market expectations compel public companies to cooperate with their auditors or to face serious consequences.

CONCLUSION

To summarize, with little additional cost and within the existing legal and regulatory framework, the SEC and PCAOB could facilitate an increase in competition over audit quality by requiring public companies to disclose the number of financial frauds that the independent audit uncovers and audit adjustments within specified dollar ranges. In addition to encouraging competition regarding audit quality, the proposal may ultimately help to reduce concentration in the audit industry, offer important incentives to improve the quality of audits and to detect fraud, help

65. See, e.g., Hammersley, Myers & Shakespeare, *supra* note 54.

auditing firms attract and retain human capital, and enhance investor protection and communication, especially as to fraud detection.

Even if our imaginations cannot stretch to accept Kermit's reference to Sarbanes-Oxley as "Green SOx," his trademark song, "*(It's Not Easy) Bein' Green*,"⁶⁶ nevertheless offers an important insight. As I listen to Kermit sing, "It could be nicer bein' red, yellow, or gold . . .," I am reminded that one day, not all that long ago, Arthur Andersen was recognized as the "gold standard" in auditing.⁶⁷ The title of this conference, "Sarbanes-Oxley Act of 2002 Five Years Later: Assessing its Impact, Charting its Future," offers the hope that, with increased competition regarding audit quality, we can one day refer to Sarbanes-Oxley as "Gold SOx."

66. KERMIT, *supra* note 1.

67. See Barrett, *supra* note 41, at 163.